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Invest with Reason

Is it Time to Abandon a Global Stock Portfolio?

For better or worse, investing is a favorite topic of cocktail party conversation. Let's say Vicky, with a globally diversified stock portfolio, ambles over at a party to compare notes with Roger, who invests in a US-only portfolio. She hears that Roger's domestic stock portfolio is up 19% year to date; her globally diversified stocks have returned only 9%. Vicky suddenly comes down with a bad case of what the Chinese call "red-eye disease": envy. She weighs cutting her foreign exposure and loading up on more US stocks.

The recent relative performance of US stocks has certainly been impressive. Year to date through July 12, US stocks gained 19% (as measured by the S&P 500 Index), compared to a 7% gain for international developed country stocks (represented by the MSCI EAFE Index) and a 12% loss for the MSCI Emerging Markets Index. During the 2 ½ year period from January 1, 2011 to June 28, 2013, US stocks returned a cumulative 35%, 26 points ahead of international and a wide 47 points better than emerging markets, which lost 12%.

Yet if Vicky switches domestic for foreign stock holdings now, she would be falling victim to what in behavioral finance is called *availability bias* – the belief that easily recalled recent outcomes (in this case, US market outperformance) will persist going forward. It is this bias that compels emotionally driven investors to buy last year's winners and sell the losers. Is "red-eyed" Vicky making a wise decision if she shifts to a domestic-dominated portfolio now?

Gerstein Fisher examined this question in two different ways: the year-by-year historical performance of individual asset classes and the global vs. domestic portfolio over extended investment cycles.

The Rise and Fall of Assets

The investment pundits on TV money and business shows like to convey the impression that they can identify winning asset classes in advance. It's not so. There will always be one asset that returns more than others, but that winning asset will almost always be different for every one- year or even six- month period. Neither we nor anyone else we know can reliably pick the winning asset class out of the myriad of options every year (or half-year) in advance.

The color chart below illustrates what we're describing. For instance, as of June 30, US large cap value stocks were the best performer among 12 different global asset classes that we surveyed. If this situation holds until the end of 2013, then this would be the first year in a decade that US large value will lead the pack – and the first year that it even places in the top three. In a similar vein, gold was at the bottom in the first half of 2013, yet dominated in 2010 and 2011. The point is that no prudent investor should attempt to pick the highest-performing asset in advance.

The Global Portfolio

Now let's focus on Vicky's domestic vs. global dilemma. Just as several years ago it was emerging markets' time to shine, today the US market may appear to be the only place to be. But we believe this, too, will be a transient phenomenon. For instance, when we looked back at the 2003-2012 decade we found that the US market placed in the top five among 24 developed-nation markets (as measured using MSCI country indices) in only two years. In seven of the ten years, the US market placed in the bottom half of these 24 countries.

In fact, over long time periods, global diversification – as opposed to US-centric investing – looks hard to beat. Gerstein Fisher studied the period from January 1, 1997 to December 31, 2012 and compared performance of global vs. domestic portfolios across rolling periods, recalculated monthly, with the initial rolling period commencing from January 1, 1997. For this study, we used the S&P 500 Index as a proxy for the US portfolio. Our global portfolio had an overweight to the US (for investors living in the US) and a market neutral balance between developed and developing countries*. We rebalanced quarterly. Result: over the 157 3-year rolling periods, the global portfolio outperformed

Individual Asset Class Performance

2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	Years in Top 3
Intl Small	Global RE	Emg Mkt	Global RE	Emg Mkt	US F.I.	Emg Mkt	Gold	Gold	Global RE	US Lrg Val	0
Emg Mkt	Intl Small	Intl Small	Emg Mkt	Gold	Intl F.I.	Intl Small	US Small	US F.I.	Emg Mkt	US Small	2
US Small	Emg Mkt	Comm	Intl Small	Comm	Gold	US Lrg Gro	Intl Small	Intl F.I.	Intl Small	US Lrg Gro	2
Global RE	Intl Lrg	Gold	Intl Lrg	Intl F.I.	Cash	Global RE	Global RE	US Lrg Gro	US Lrg Val	Intl Lrg	0
Intl Lrg	US Small	Intl Lrg	Gold	US Lrg Gro	US Small	Intl Lrg	Emg Mkt	Global RE	Intl Lrg	Global RE	3
US Lrg Val	US Lrg Val	Global RE	US Lrg Val	Intl Lrg	Comm	US Small	Comm	US Lrg Val	US Small	Intl Small	7
US Lrg Gro	Intl F.I.	US Lrg Val	US Small	Intl Small	US Lrg Val	Gold	US Lrg Gro	Cash	US Lrg Gro	Cash	0
Comm	Comm	US Lrg Gro	US Lrg Gro	US F.I.	US Lrg Gro	US Lrg Val	US Lrg Val	US Small	Gold	US F.I.	2
Gold	US Lrg Gro	US Small	Intl F.I.	Cash	Intl Lrg	Comm	Intl Lrg	Intl Lrg	US F.I.	Intl F.I.	2
Intl F.I.	Gold	US F.I.	US F.I.	US Lrg Val	Global RE	Intl F.I.	US F.I.	Comm	Cash	Emg Mkt	7
US F.I.	US F.I.	Cash	Cash	US Small	Intl Small	Cash	Intl F.I.	Emg Mkt	Comm	Comm	2
Cash	Cash	Intl F.I.	Comm	Global RE	Emg Mkt	US F.I.	Cash	Intl Small	Intl F.I.	Gold	4

2003-2012 reflect full calendar years; 2013 is from Jan. 1, 2013 to June 30, 2013
Source: Bloomberg, Gerstein Fisher Research
Asset class constituents as follows: US Large Cap Value – Russell 1000 Value, US Large Cap Growth – Russell 1000 Growth, US Small Cap – Russell 2000, Emerging Markets – MSCI Emerging Markets Index, International Large Cap – MSCI EAFE, International Small Cap – MSCI All Country World ex USA Small Cap Index, International Fixed Income – Citi World Gov't Bond Index Ex US 1-5 Years, US Fixed Income – Five Year US Treasuries, Commodities – Dow Jones-UBS Commodity Index, Cash – 1-Month Treasuries, Global Real Estate – S&P Global REIT Index

domestic 68% of the time. But as the investment horizon extended to 10-year rolling periods, the global portfolio beat US-only 100% of the time, with an average outperformance of two percentage points annualized. In other words, the longer the time period examined, the better diversification performed.

Keep in mind that, despite a trend of rising correlations among global stocks, different markets still react to local factors such as differing monetary and fiscal policies, inflation rates, interest rate environments, and business cycles. It just seems more prudent to own a broadly diversified global portfolio of stocks than one limited to domestic-only stocks, wherein the investor is subject to the vagaries of a single economy's business cycle, politics and currency. In 2012, the US economy generated 23% of global GDP (Source: World Bank), yet as of May 31, 2013 US stock markets accounted for fully 49% of global market capitalization (Source: MSCI). That doesn't sound like a sustainable situation. As long-term investors, we believe that Vicky should stick with her globally diversified portfolio.

Conclusion

The recent strong performance of US stock markets has caused many American investors to feel anxious about international investing and to question the merit of globally diversified portfolios. We believe at some point other global asset classes will take the baton from domestic stocks, but the timing of that transition is difficult or impossible to predict in advance. A review of extended investment time frames, such as 10-year rolling periods, reveals that global diversification has consistently produced superior returns for domestic investors.

*For the global portfolio, we used a 64/23/13 blend of S&P 500 Index, MSCI EAFE Index and MSCI Emerging Markets Index.

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